April 30, 2015

Ms. Susan M. Cosper
Technical Director
File Reference No. 2015-220
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116
Via email to director@fasb.org

RE: Proposed Accounting Standards Update—Derivatives and Hedging (Topic 815): *Disclosures about Hybrid Financial Instruments with Bifurcated Embedded Derivatives*

Dear Technical Director Cosper,

On behalf of the American Academy of Actuaries'[1] Financial Reporting Committee, I would like to submit the following comments regarding the proposed Accounting Standards Update (ASU)—Derivatives and Hedging (Topic 815): *Disclosures about Hybrid Financial Instruments with Bifurcated Embedded Derivatives.* As discussed in our letter to the Financial Accounting Standards Board (FASB) dated June 30, 2014[2] on targeted improvements to insurance contract reporting, we have similar suggestions relating to the treatment of insurance contracts that contain embedded derivatives that fall under Topic 815.

The bifurcation of certain embedded derivatives that occur within some insurance contracts can create unnecessary complexity. For example:

- Many modified coinsurance (reinsurance) contracts and funds-withheld contracts contain an embedded derivative providing for the payment of investment income to the reinsurer that depends on the returns on assets held by the ceding company. Bifurcating these embedded derivatives is complex and only provides information of minimal value. We have previously suggested using current discount rates and other assumptions to measure insurance contracts. If this approach is adopted, the key information that would be provided by bifurcating these embedded derivatives would already be included in values within financial statements in a manner that is consistent with other valuation elements of

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.
[2] Academy letter to the FASB regarding the Proposed Accounting Standards Update: Insurance Contracts (Topic 834) exposure draft: http://actuary.org/files/AAA_letter_on_targeted_improvements_063014.pdf.

the contract. Thus, it would be possible to both provide relevant information and simplify the valuation process by not requiring bifurcation of these embedded derivatives.

- Although equity-indexed insurance and annuity contracts contain embedded derivatives that should be bifurcated, we have concerns with the established boundary of the equity-indexed embedded derivative. Under existing U.S. generally accepted accounting principles (GAAP), the current guarantee is bifurcated along with all future guarantees. While it is appropriate to bifurcate the current guarantee, bifurcating future guarantees leaves a host insurance contract that effectively locks in all future returns. This is not consistent with the actual floating returns of the contract. Complexity can be reduced and representational faithfulness can be enhanced by limiting the bifurcation of equity-indexed embedded derivatives to the current period guarantee.

In addition, the FASB has indicated interest in how insurance contracts are managed as part of the insurance contracts project. Topic 815—as applied to modified coinsurance contracts, funds-withheld contracts, and equity-indexed contracts—provides limited useful information and, in the case of periods beyond the current guarantee of equity-indexed contracts, is not consistent with business practice.

The value of the embedded derivative can be determined using Black-Scholes or other valuation technique for equity-indexed products for the current guarantee period. The current guarantee period is typically one year from the date of deposit or renewal of deposit into the index fund. This embedded derivative is frequently hedged by purchasing appropriate assets.

The most common method of bifurcation is the "option budget method." This method assumes that, after the current guarantee period, the company will have a fixed proportion of invested funds or account value to purchase future hedges, with their return approximating the cost of the hedges. The insurance contract limits the cost of these future hedges by allowing discretion as to the amount of participation the contract holder will have in the growth of the index and/or capping the total return, or other limiting methods specifically allowed by the contract.

While there are limits to the discretion allowed in setting certain insurance contract features, such as participation rates and caps, etc., the insurer still has enough flexibility to set other features including the renewal terms to target a certain option budget. Thus, these limits are not always accounted for under current GAAP techniques for practical purposes considering materiality, whether doing a full version of the bifurcation accounting or using a simplified approach. In the rare cases in which these limits drive renewal terms, the impact could be captured in loss recognition testing in accordance with FASB Accounting Standards Codification 944-60-25 *Premium Deficiency and Loss Recognition-Recognition*. A recent article indicated that 70 percent of 21 large issuers of indexed universal life products used a simplified approach. [3] One of the reasons cited for using this approach was the complexity of non-simplified approaches. Non-simplified approaches also have results that are much harder to explain.

[3] Katie Cantor and Guillaume Briere-Giroux, "Indexed Universal Life: US GAAP Financial Reporting Practices," Issue 100, The Financial Reporter, SOA, March 2015, https://www.soa.org/news-and-publications/newsletters/life-insurance-company-financial-reporting/pub-life-insurance-company-financial-reporting-newsletters.aspx.

Therefore, we believe amending Topic 815 to (1) eliminate the bifurcation of modified coinsurance contracts and funds-withheld contracts and (2) limit the bifurcation of indexed contracts to the current index period will improve the understandability and consistency of financial reporting and will more closely align with current business and valuation practices.

*****

Thank you for this opportunity to provide additional feedback on the FASB's disclosures about hybrid financial instruments with bifurcated embedded derivatives. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries